COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

LINCOLN SAVINGS AND LOAN ASSOCIATION,

Respondent.

Brief in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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IN THE

Supreme Court of the United States

October Term, 1970
No. 544

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

LINCOLN SAVINGS AND LOAN ASSOCIATION,
Respondent.

Brief in Opposition to Granting a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Statement.

The petitioner's statement of the case should be corrected and amplified as follows:

a. Page 5. The statement is made that "An insured institution * * * does have an interest, however, in the Secondary Reserve, which * * * is used to pay the institution's regular insurance premiums in future years * * *." Actually, the Secondary Reserve is available to the FSLIC primarily to meet its losses, a circumstance wholly beyond the control of any insured institution; and only if and to the extent not so used

will it be available to pay the institution's regular insurance premiums.[1]

b. Page 6. Although conceding that the right, title or interest in the Secondary Reserve is not generally transferable or assignable, the petition states that the FSLIC has authority to authorize transfers in mergers, etc. Actually, the statutory language is as follows (Petition, Appendix G, p. 89):

> "No right, title, or interest of any institution in or with respect to its pro rata share of the Secondary Reserve shall be assignable or transferable, whether by operation of law or otherwise, except to such extent as the Corporation may by regulation or otherwise provide for transfer of such pro rata share in cases of merger or consolidation, transfer of bulk assets as defined by the Corporation by regulation or otherwise for the purposes of this sentence, and similar transactions as so defined."

The FSLIC has made provision *only* for transfers in mergers or consolidation,[2] and for no others. See Sec-

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[1]While this has not been a problem to date, it could become one. It is a fact of legal significance, however, in view of the petitioner's assertion (Page 12) that the Secondary Reserve payment "could be called a forced loan, but it is a loan." A "loan" carries with it an unconditional obligation to pay on demand or on a specified date a sum certain in money. The primary requirement of the payment here was to provide the FSLIC with a reserve to cover its losses; and if so used there would be no obligation whatever to repay or to use the reserve to pay the insured's regular insurance premiums in any future year.

[2]A transfer in a merger or consolidation does not result in the fruition or realization of the institution's "pro rata share of the Secondary Reserve." Instead, it merely represents a continuance in the institution's illusory interest in such reserve. With or without a merger or consolidation, the institution's protection and interest, emanating from both the Primary and Secondary reserves, will continue.

tion 563.16-2 of Rules and Regulations For Insurance of Accounts, Appendix A, page 1.

c. Pages 6 and 7. The petition states that an insured association is entitled to a cash refund in four instances:

(1) Its status as an insured institution is terminated. The Tax Court found that in the opinion of the taxpayer's management "loss of its insured status with the FSLIC would cause a mass withdrawal of savings by its depositors." (Petition, Appendix A, p. 23). This would be tantamount to a cessation of business by the institution and would then impose on the FSLIC the extreme financial burden of meeting depositors' demands from the liquidation of their accounts.

(2) A liquidating receiver has been appointed.

(3) The FSLIC determines that the association has gone into liquidation (the word "voluntary" was supplied by petitioner in its statement). The occurrence of either event (1), (2) or (3) would make the Secondary Reserve available for exactly the purpose its payment was required in the first instance, namely, insurance of savings account depositors.

(4) The Primary Reserve alone reaches two percent of insured accounts and creditors' obligations of all insured associations. The estimates of the FSLIC were that the entire Secondary Reserve would be transferred to the Primary Reserve and there would never be any cash refund to an insured institution [Ex. 13-M].

ARGUMENT IN OPPOSITION TO GRANTING THE WRIT.

1. This Is Not a Case of Substantial Fiscal Significance.

The petitioner asserts that this case is "of substantial fiscal" significance, as one reason for granting the petition for a writ of certiorari. It states (pp. 8 and 9) that claims for refund on tax on this issue amount to $72.5 million, and that statutory interest on such claims (at six percent) amounted to $22 million at August 15, 1970.

The taxpayer is at a disadvantage in this area, because the foregoing figures are not in the record and their accuracy cannot be verified.

The petition goes on to state (p. 8) that an estimated 2,000 associations have not filed claims but are free to do so within the statute of limitations. There is nothing in the record or out of it to support this assertion. We are not advised how many associations deducted the payments but without tax benefit, and hence could not file claims for refund. We do not know how many associations deducted the payments and were allowed the deductions, whether audited or not. We do not know how many associations were awarded refunds on their claims for refund. We do know that the taxpayer in *First Federal S. & L. Assn. of St. Joseph v. United States* (W. D. Mo.) 288 F. Supp. 477, was tendered a refund of the entire tax paid on this issue, but declined it, preferring a judgment on the merits; and that following a judgment in its favor the United States did not appeal the adverse decision.

Accepting as correct the petitioner's figure regarding the tax involved in pending claims for refund, we respectfully submit that no showing has been made that this is a case "of substantial fiscal" significance.

In footnotes 5 and 6 of the petition (pp. 5 and 6) it is recognized that Congress in 1969 amended the National Housing Act to eliminate "creditors obligations" in determining when the required two percent level would occur, and that such level was reached in 1969 instead of the originally-projected 1970. As a consequence, the petition (footnote 6, page 6) recognizes that "Beginning this year, the Secondary Reserves are being used to meet the insured institutions' obligations for Section 404(b) payments. FSLIC has not yet prepared a new projection based on the 1969 amendment, but there is no reason to expect that the new estimates will vary significantly from the previous estimates."

What are these "previous estimates"? They are set forth in Exhibit 13-M, and they show that the regular premiums to be paid into the Primary Reserve would be as follows:

1971	$132.3 million
1972	141.9 million
1973	151.7 million
1974	161.8 million
1975	172.3 million

(Schedule B of Exhibit 13-M)

They also show that the Secondary Reserve would be depleted by transfers to the Primary Reserve of exactly the same amounts, as follows:

1971	$132.3 million
1972	141.9 million
1973	151.7 million
1974	161.8 million
1975	172.3 million

(Schedule C of Exhibit 13-M)

In other words, the estimates of the FSLIC were that in the five years 1971 through 1975 regular insurance premiums into the Primary Reserve would aggregate $760 million, but that there would be no payments of such premiums by insured associations. There would be, instead, bookkeeping transfers of $760 million from the Secondary Reserve.

And, what is of primary importance, the petitioner concedes and contends that all the insured institutions will be entitled to income tax deductions upon such transfers, although no payments will have been made in those years by insured institutions.

The petitioner concedes that the 1969 amendment has accelerated such transfers, to begin in 1970 instead of 1971. The result is that on the FSLIC's estimates, in 1970 there will be a transfer of $132.3 million from the Secondary Reserve to the Primary Reserve, all of which on its theory will provide income tax deductions to insured institutions; and in 1971 there will be a transfer of $141.9 million.

Thus, under the petitioner's argument insured associations will be excused from paying primary premiums in 1970 and 1971 of $274 million, but they nevertheless will be entitled to deduct such amounts in computing their federal income tax liabilities for 1970 and 1971. Such deductions, assuming an effective tax rate of 50 percent, would result in a reduction of Federal revenues for 1970 of $66.1 million and for 1971 of $70.9 million, or a reduction in Federal revenues for the two years of $137 million.

Admittedly these are rough figures, and conceivably the tax involved for such two years might be less than $137 million. But the point is that the Government's

loss of revenue is going to be very substantial in this and the immediately following year—whether it refunds the $72.5 million under claims for refund for earlier years or whether the revenues for the current years are simply reduced by current deductions.

And the statutory interest cited by the petitioner is not a matter of great fiscal significance. The petitioner has had the use of the taxpayers' money (to which it was not entitled under the decisions below and of two District Courts) and in today's money market a 6 percent rate of interest is a bargain rate—less than the Treasury pays currently for borrowed funds, and assuredly less than the taxpayers could have earned with the same funds in the conduct of their businesses.

Accordingly, we respectfully submit that petitioner has made no showing that this is a case of substantial fiscal significance.

2. This Is Not a Case of Substantial Administrative Difficulties.

The petitioner's claim of "administrative difficulties" (pp. 9-11) is likewise unfounded.

The petitioner's position is that (a) taxpayers will have to take inconsistent positions by claiming the deductions in both years and (b) the Government will have to take inconsistent positions by denying the deductions in both years. But this argument is based upon a very important assumption: "if the statute of limitations runs on the later years while the earlier years are not closed by the statute of limitations" (p. 10).

The answer is that the statute of limitations will not and cannot bar a deduction at one time or another, nor can it operate to allow any taxpayer a double deduction.

In footnote 10, page 10 of the petition, it is explained that Sections 1311(b)(2)(B) and 1312(4) of the Code "lift the bar of the statute of limitations in certain cases", but the petitioner asserts in the footnote that "savings and loan associations could not safely avoid filing protective claims for the later years in reliance on Sections 1311(b)(2)(B) and 1312(4)."

The petitioner overlooks the statute that applies here, namely, Section 1312(7)(C)(iii). That provision lifts the bar of the statute of limitations when a determination determines the basis of property and in respect of any transaction which was erroneously treated as affecting such basis there occurred any of the errors specified in subparagraph (C), of which (iii) is as follows:

> "(iii) there was an erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible."

This is exactly the situation we have here, and it is exactly the reason why Congress lifted the bar of the statute of limitations so that, in controversies as to whether an item should be expensed or capitalized, the Government would not be damaged by inconsistent deduction of the same item twice nor would taxpayers be damaged by disallowance of any deduction by failing to choose the proper time for deduction.

The Senate Finance Committee stated as follows in Senate Report 1622, 83rd Congress, 2nd Session, accompanying the bill that became the Internal Revenue Code of 1954 (p. 448):

> "The type of errors described in the basis provision have been expanded to include the er-

roneous allowance of a deduction for an expense properly charged to capital account or, conversely, the erroneous charging to capital account of an expense properly deductible. Thus, if the taxpayer erroneously expenses certain costs which should be capitalized and later successfully contends that such amounts should have been added to the basis of the asset, an adjustment will be authorized under section 1311. Similarly, if the taxpayer erroneously capitalizes certain costs and the Government requires that such items be eliminated from basis, relief will be provided the taxpayer under section 1311."

Petitioner claims that the payment in question here was not an ordinary and necessary business expense but was a capital investment—the cost of a capital asset. The taxpayer contends that the payment was an expense and deducted it as such. Exactly the situation contemplated by Section 1312(7)(C)(iii).

We have only four possible situations here, and we respectfully submit that none of them poses any administrative difficulty to the Government or to the taxpayers:

1. A taxpayer, such as the taxpayer here, may have deducted the payments as they were made. If that was the correct treatment, that ends the matter. Such a taxpayer clearly would not be entitled to a later deduction when the FSLIC makes a bookkeeping entry transferring an amount from its Secondary Reserve to its so-called Primary Reserve.

2. If it is ultimately determined that a current deduction was not proper, but that a capital asset was acquired, then the taxpayer could clearly deduct the

amortization of such capital cost in later years, regardless of the statute of limitations, under Section 1312-(7)(C)(iii). So, in the meantime unnecessary protective claims for refund need not be filed, as the petitioner asserts.

3. Other taxpayers may not have claimed current deductions. They then will be entitled to later deductions under the petitioner's theory, if that theory be correct, and as to such taxpayers there is no problem.

4. But if the petitioner's theory ultimately is held to be incorrect and the later deductions are disallowed, any such taxpayer could file claim for refund for earlier years under Section 1312(7)(C)(iii), regardless of any statute of limitations.

Hence, we respectfully submit that there is no merit in the petitioner's argument that the necessary taking of inconsistent positions by taxpayers and by the Government poses "administrative difficulties". There simply is no necessity for taking inconsistent positions on either side in view of Section 1312(7)(C)(iii). This statutory provision was not in effect at the time the decision was rendered in *Wichita State Bank & T. Co. v. Commissioner*, 69 F. 2d 595, as well as other decisions in similar situations, upon which the petitioner places great reliance.

3. The "Merits" Do Not Warrant Review by This Court.

Under numeral "2" the petitioner alleges that on the merits little can be added in support of what Judge Raum said in the Tax Court (Petition, pp. 11-15). That this statement is correct is indicated by petitioner's restatement of what Judge Raum said and what the Government urged in the Ninth Circuit.

In opposition, the taxpayer can say that little can be added to what Judge Fulton said in *Washington Federal Savings and Loan Assciation of Miami Beach v. U.S.* (U.S.D.C. So. Dist. Fla., 1969), 304 F. Supp. 1072, on appeal in the Fifth Circuit. Judge Fulton had before him the Tax Court opinion and adequately refuted it in all essentials; and his opinion was virtually adopted by the Ninth Circuit. See petition, Appendix B, pages 65, 71.

But there are a few comments the taxpayer should make regarding the merits in view of the petitioner's argument:

(a) All that a savings and loan association is seeking in this litigation is the same income tax deduction that the Internal Revenue Service has allowed for decades to banks with respect to their payment of insurance premiums to the Federal Deposit Insurance Corporation. Banks pay insurance premiums to the Federal Deposit Insurance Corporation, just as savings and loan associations pay insurance premiums to the FSLIC. In the case of banks the payments build up credits for the ensuing year, just as payments by savings and loan associations may build up credit for ensuing years. But the Internal Revenue Service permits a current deduction of such payments by banks, notwithstanding benefits in subsequent years. See I.T. 2764, C.B. XIII-1, 45, and Rev. Rul. 62, C.B. 1953-1, 71.

(b) On page 12 the petitioner suggests that the secondary premium is a forced loan. This concept of an indebtedness is wholly inconsistent with the views consistently expressed by the Commissioner of Internal Revenue. It has always been the Government's position

that the basic characteristics of a loan include an unconditional promise to pay on demand or on a specified date a sum certain in money. Interestingly enough, there exists here none of these required characteristics.

(c) The petition adds a new concept to deductible expenses when it states, as a basis for disallowance of the secondary reserve premiums, that the payments "are not consumed during the taxable years in which they are made." The petitioner does not inform us what "consumption" means as it relates to the facts of this case. Presumably, petitioner is relating "consumption" with his conclusion that the taxpayer retains a "beneficial interest" in the secondary reserve payment. At least this is the implication from reading the succeeding sentence. Yet, petitioner fails to recognize that the taxpayer "retains a beneficial interest" in the payments made to the primary reserve. In fact, the beneficial interest is the same. Yet, the petitioner concedes that the Primary Reserve premium is deductible when paid (Petition, Appendix G, pp. 86, 87). The taxpayer is assured that its customers' savings accounts are insured and that, eventually, it may be relieved of making any insurance premium payments whatsoever. But that "benefit" would accrue as a result of the payment of both the primary premium and the secondary premium. It is true that when the combined reserves reach the 2 percent level the taxpayer will enjoy a benefit in not having to pay insurance premiums, but it is also true that all associations will enjoy such a benefit when the primary reserve alone reaches 2 percent, and the latter is true when an association has or has not ever paid a secondary premium. The possibility of possible future benefit is and always has been inherent in the

statutory scheme of creating an insurance reserve for the FSLIC, for premiums have always been terminable when the reserve reached a designated level. Hence, in this important respect, *i.e.*, possible future benefit, there is no fundamental distinction between the primary premium and the secondary premium.

(d) The petitioner's assertion (p. 12) that the FSLIC "is required by law to segregate that (secondary) reserve from its other assets" is erroneous. There is no segregation of assets in fact or required by law. All that occurs is that on its financial statements the FSLIC divides its reserves (on the liability side of its balance sheet) into two accounts, a Primary Reserve and a Secondary Reserve. But it is important to observe that both reserves serve exactly the same purpose, namely, a reserve for losses; and they both appear as reserves on the financial statements, not as current or long-term debts, as would the Secondary Reserve appear if it really represented a "loan" from associations.

(e) The petitioner's conclusion (p. 13, Footnote 12) that the intended function of the Secondary Reserve was to replace the permanent pool of capital represented by the Federal Home Loan Bank stock is totally unwarranted. The purchase of stock was to provide capital from which loans could be made, whereas the payments into the Secondary Reserve were for the sole purpose of providing reserves for losses, which might reasonably be expected by the FSLIC.

(f) The petition asserts (p. 14) that the decision of the Ninth Circuit repudiates a matching of costs and revenues.

Under the Government's theory, the taxpayers for 1970 should report taxable income decreased by an in-

surance premium it did not pay in that year, and that by virtue thereof its Federal income tax liability is less than it would be if it had not deducted the insurance premium which it did not pay. We can conceive of no better way to distort income than the Government suggests, both in the year of payment and in the year the payment is transferred by bookkeeping entry from the FSLIC's Secondary Reserve to its Primary Reserve. In truth and substance the money is gone in the year in which it is paid, and paid for insurance protection for its customers, and any benefit derived later from not paying a premium would be a benefit, not a subtraction from, the later year's taxable income.

(g) The petition states (pp. 14-15) that it is not surprising that Peat, Marwick & Mitchell certified the taxpayer's financial statements, in which the secondary premiums were capitalized, as being in accord with generally accepted accounting principles.

It may not be surprising, but on the other hand such certification does not necessarily make it right. The Internal Revenue Service would be the last to contend that an opinion of a certified public accountant necessarily furnishes the one and only sound answer for income tax purposes. If it did, the hands of the Internal Revenue Service would be effectively tied.

"Generally accepted accounting principles" mean just that, namely, that a given treatment of an item has been accorded some general acceptance. The general acceptance can come from a number of different sources, such as acceptance by state or federal regulatory agencies; but such acceptance does not mean that a given treatment of an item is the only treatment of that item having general acceptance, or even that the given treatment

is the most sound or accurate. Indeed, it is common knowledge that the same item will be treated differently by different corporations, and yet reputable accounting firms are able to certify as to the financial position of both corporations with respect to their respective balance sheets and statements of operations.

This principle is explained by Paul Grady in the "Inventory of Generally Accepted Accounting Principles For Business Enterprises", an accounting research study published in 1965 by the American Institute of Certified Public Accountants, Inc., which discusses the matter at pages 50-53, and states that an accounting practice will be "generally accepted" if it has the support of regulatory commissions.

Thus, the fact that capitalization of the secondary reserve premium was decreed by regulations of the California Savings and Loan Commissioner and by the Federal Home Loan Bank Board (petition, page 7) was sufficient to enable Peat, Marwick & Mitchell to certify that such treatment was in accord with "generally accepted accounting principles."

But such treatment was severely criticized by the two expert witnesses who testified in the present case, both eminently qualified, namely, Robert T. Sprouse, Professor of Accounting at the Graduate School of Business at Stanford University [Rep. Tr. pp. 43-61], and Wayne S. Boutell, Associate Dean of the School of Business Administration at the University of California at Berkeley [Rep. Tr. pp. 67-79].

The capitalization of such payments has recently been condemned by two prominent accountants, Karl M. Skousen, Professor and Chairman of Accounting, Brigham Young University, and K. Fred Skousen, As-

sistant Professor of Accounting at the University of Minnesota, in an article entitled "Savings and Loan Secondary Reserve Payments—Assets or Expenses?" published in the August, 1970 issue of "C.P.A.", monthly journal of the New York State Society of Certified Public Accountants, which is reproduced in this brief as Appendix B, pages 2-21. The headnote of the article reads:

> "Accounting by Government fiat, with the aim of bolstering a financially concerned industry having a major public interest, usually results in 'bootstrap uplift' measures. The statutory dispensation for treating secondary reserve payments as assets, the authors demonstrate, materially distorts financial statements of savings and loan associations. * * *"

4. This Case Presents No Conflict Between Circuit Courts Regarding Compulsion to Pay.

As its third reason for granting the writ, the petitioner states (page 16) that the portion of the majority opinion below "emphasizing the element of economic compulsion conflicts in principle with the conclusion of the Court of Appeals for the Eighth Circuit in *M.F.A. Central Cooperative v. Bookwalter*, 70-1 USTC, par. 9484." The petitioner asserts that while this case and the cooperative cases arise in different contexts, the question, insofar as the significance of economic compulsion is concerned, is identical, and is one that warrants consideration by this Court.

We respectfully submit that the foregoing assertion has no relevance here.

Petitioner asserts (p. 16) that *M.F.A. Central Cooperative v. Bookwalter, supra,* is squarely in conflict

with *Penn Yan Agway Cooperative, Inc. v. United States* (Ct. Cl.) 417 F. 2d 1372. But there is no conflict between those two cases on the vital issue decided in the instant case: namely, whether a payment constitutes an ordinary and necessary business expense or a capital expenditure. The Court of Claims in the latter case held that the payment there was deductible as interest—a bonus for a loan, rather than as an ordinary and necessary business expense. As the Court stated in the *M.F.A. Central Cooperative* case:

> "* * * The Court of Claims * * * discusses quite extensively the statutory background and purpose and considers the deductibility of the required amount paid for Class C stock purchases as a business expense *but it does not base its decision on the ground that the stock purchase price is a business expense.* * * *" (Emphasis added.)

The Court then concluded that the taxpayer "has not met the burden of establishing that the expenditure here involved is an ordinary expense."

Hence, we respectfully submit that there is no conflict between the two cases on the question of deductibility of business expenses.

But of even greater significance here is that the taxpayer in the present case has not contended, and the Court of Appeals for the Ninth Circuit did not hold, that an otherwise capital expenditure is converted into an expense item because the payment was made under legal or economic compulsion. Compulsion, whether legal or economic, should have no bearing upon the question whether a payment is an expense or a capital expenditure. That basic question should always be governed by the rights acquired as a result

of the payment, whether made voluntarily or under compulsion.

In the present case the taxpayer has contended that the rights, if any, it acquired by the payment in question were not sufficient to constitute a capital asset and hence the payment was not a capital expenditure. The Court of Appeals for the Ninth Circuit agreed with this contention (see its opinion in Appendix B of the petition, pp. 66-70). As heretofore stated, two District Courts have also agreed with this contention.

The question then becomes whether the payment, although not a capital expenditure, is an "ordinary and necessary business expense", so as to be deductible under section 162(a) of the Internal Revenue Code (Petition, Appendix E, p. 77).

It was at this point that the Court of Appeals for the Ninth Circuit referred to economic compulsion, in saying that a payment which must be made to stay in business fulfills "our conception of an 'ordinary' business expense." (Petition, Appendix B, p. 71).

We submit, therefore, that there is no merit in petitioner's attempt to display a conflict between the circuit courts on this point in the present case.

Conclusion.

The petition alleges (p. 11) that resolution of the question involved here "can be provided only through review by this Court at this time."

The taxpayer disagrees.

If resolution of the issue had been so important a federal question it is difficult to understand the Government's failure to appeal the adverse decision on June 17, 1968 in *First Federal Savings and Loan As-*

sociation of St. Joseph v. United States (D.C., W.D. Mo.) 288 F. Supp. 477.

But even more important is the Government's pending appeal to the Fifth Circuit of the adverse decision in *Washington Federal Savings & Loan Association of Miami Beach v. United States* (S.D. Fla.) 304 F. Supp. 1072. If the Government should prevail in that case there would then be a clear conflict between Circuit Courts, warranting resolution by this Court. But if the Fifth Circuit reaches the same conclusion as did the Ninth Circuit and the two District Courts, there would be no conflict; and it is to be hoped that the Internal Revenue Service would remove further difficulty by a sensible administrative promulgation. This case is no different than the many instances where the Commissioner, to serve his own purposes, refuses to follow circuit court decisions.

The petition has not established the importance usually deemed necessary for review of this case by this Court.

The petition for a writ of certiorari should be denied.

September 11, 1970.

Respectfully submitted,

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APPENDIX A.

Section 563.16-2 of the FSLIC Rules and Regulations For Insurance of Accounts, Chapter V(D), Title 12, Banks and Banking, Code of Federal Regulations:

"Except as provided in the next following sentence or by action of the Corporation pursuant to the last sentence of said subsection (e), no right, title, or interest of any institution in or with respect to its pro rata share of the Secondary Reserve shall be assignable or transferable, whether by operation of law or otherwise. In the event that an insured institution (hereinafter in this sentence called the surviving institution), the merging institution's pro rata share of the Secondary Reserve shall automatically be transferred to the surviving institution, and in such event the amount of the increase in all accounts of the surviving institution's insured members as of the December 31 next following such merger shall, for premium prepayment purposes, be adjusted by the Corporation so that such increase shall not include the accounts of insured members of the merging institution as of the close of the immediately preceding December 31."

APPENDIX B.

Savings and Loan Secondary Reserve Payments—Assets or Expenses?

By Karl M. Skousen and K. Fred Skousen

Accounting by government fiat, with the aim of bolstering a financially concerned industry having a major public interest, usually results in "bootstrap uplift" measures. The statutory dispensation for treating secondary reserve payments as assets, the authors demonstrate, materially distorts financial statements of savings and loan associations. In conclusion they set forth proposed steps that may make the statutory "bootstrap" unnecessary.

The question at issue here is whether or not Secondary Reserve (SR) payments (mandatory "prepayments," supplementing yet distinguished from regular insurance premium payments), now required of savings and loan association by the Federal Savings and Loan Insurance Corporation (FSLIC), should be recorded and classified for financial reporting purposes as assets or as expenses of operation.[1]

Current accounting practice records these payments as assets. To the extent that these payments are so treated, when asset characteristics are lacking and expense characteristics prevail, published financial statements of savings and loan associations are unrealistic and do not "present fairly the financial position and results of operations." Such a possibility, it seems to the writers, merits serious consideration by independent public accountants in the performance of their attest function.

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[1]Other questions raised by the applicable law and subsequent regulations, such as the deductibility of these payments for tax purposes, are outside the scope of this paper.

In determining how SR payments should be treated for accounting purposes, two primary questions (and their sub-issues) need to be considered. First, and of primary importance, do these so-called "prepayments" have the characteristics of asset? Second, if the "prepayments" do qualify as assets, what measurement problems exist? Obviously, if the payments do not qualify as assets, rather they qualify as expenses, they should not be capitalized. In order to view these questions in proper perspective, it is necessary to review the background of the problem.

BACKGROUND OF THE PROBLEM

FSLIC was created by Title IV of the National Housing Act of 1934 for the purpose of providing stability and restoring public confidence in the savings and loan industry. It is an instrumentality of the federal government, established by Congress to provide a minimum level of security for depositors' (shareholders') savings accounts at federally insured savings and loan associations.

The initial plan insured accounts up to $5,000 at an annual cost of ¼ of 1% of insured savings accounts. Later the premium cost was reduced to ⅛ of 1%. and in 1946 attempts were made to further reduce the premium to 1/12 of 1%. This latter attempt was unsuccessful, primarily because of insufficiency of FSLIC reserves. The original statute called for annual premiums until such time as FSLIC reserves reached 5% of the total amount of all accounts of insured members. In 1946 the reserves were well below 5%; actually, they were less than 2%.

In 1950 legislation was passed which, among other things, reduced the premium to 1/12 of 1% and increased insurance coverage to $10,000. However, during the 1950's insured savings increased much more rapidly than did FSLIC reserves, resulting in a steady decline in its reserve ratio. (In 1959 it was only 0.661%).[2] This brought pressure to increase the premium back to ⅛ of 1% and led directly to an alternative plan proposed by the United States Savings and Loan League.

The Prepayment Expediency. The alternative proposal provided for an additional premium, called a "prepayment," by each member association into a "Secondary Reserve" of the FSLIC. The impact was cushioned by the provision that the "prepayments" were to be treated by the association as assets. The plan further provided that the FSLIC credit each member association's SR account with a "return" (interest) on cumulative payments.[3] However, this return, although considered operating income to each association, was not to be paid in cash. In fact, it could not be withdrawn in the regular course of business, nor could it be applied directly to Primary or Secondary Reserve payments.

The effect of the proposed plan on association financial reports obviously is that whereas as ordinary increase in premium costs would have decreased re-

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[2]Report of a subcommittee appointed to inquire into the nature of payments into the Secondary Reserves of the FSLIC, Committee on Savings and Loan, California Society of Certified Public Accountants, August, 1968, p. 4.

[3]Such return was to be based on the average annual rate received by the FSLIC on its government portfolio.

ported net income, capitalizing them would improve reported profits and financial position.

Secondary Reserve Impact on Financial Statement Reporting*

S & L Assn.	% of Total SR to Total Assets	Current Year SR Increase $	Current Year SR Increase % of Net Income	Earnings Per Share $‡	Earnings Per Share $—Less Year's SR Increase	Increase in Earnings Per Share by Capitalization of SR $	Increase in Earnings Per Share by Capitalization of SR %
A	1.05%	$ 591,896	15%	$2.08	$1.76	$.32	18%
B	1.05	4,025,328	31	1.23	.85	.38	45
C	.84	148,639	20	.70	.56	.14	25
D	1.36	341,769	19	1.47	1.19	.28	25
E	.80	126,648	9	1.63	1.48	.15	10
F	1.29	629,501	14	(1.60)†	(1.83)	(.23)	(13)†
G	.99	32,222	20	.36	.29	.07	24
H	1.05	288,463	18	1.59	1.31	.28	21
I	.92	49,196	45	.68	.37	.31	84
J	.96	34,150	16	.10	.08	.02	25
K	.48	88,245	9	1.47	1.33	.14	11
L	1.20	210,583	12	.75	.66	.09	14

*The data presented in this table were obtained from 12 savings and loan association's 1967 and 1968 annual reports to shareholders, selected at random from among the 44 associations which file with the Securities and Exchange Commission.

†Decrease in loss per share.

‡Before extraordinary items.

The accompanying table shows the effect on the balance sheet and the income statement resulting from the capitalization of SR payments. The amount accumulated to date in the SR account as a percent of total assets is insignificant, usually about one percent. But when compared to net income before extraordinary items the current year increase in the SR is material, typically between 10 and 20 percent.

The effect on the income statement is much more pronounced than on the balance sheet. By capitalizing

SR payments instead of charging them as operating expenses, reported earnings per share figures are significantly improved, usually more than 15 percent. (See Table.)

Changes in SR Payments. Legislation enacted in September, 1961, Public Law 87-210, followed closely the general provisions of the United States Savings and Loan League plan just summarized. More specifically, it provided that member associations of the FSLIC continue to pay into a general reserve, called the Primary Reserve (PR), an annual premium equal to 1/12 of 1% of the total amount of all savings accounts and creditor obligations outstanding; pay an additional yearly premium into an SR equal to 2% of the net increase in all accounts of the association during the preceding calendar year, less an amount equal to requirements for purchase of stock of a Federal Home Loan Bank;[4] and receive credit on the books of the FSLIC for interest on cumulative SR payments.

Public Law 91-151, enacted in December, 1969, effective January 1, 1970: (1) reduced payments to the Primary and Secondary reserves by eliminating "creditor obligations outstanding" from consideration in premium or reserve calculations; (2) gave authority to regulate rates of interest or dividends on time and savings deposits; increased account protection to insured savers from $15,000 to $20,000; and (4) gave authority the Treasury Secretary to lend an additional $3 billion to the FHL Banks.

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[4]With the enactment of this legislation, the requirement that insured associations hold Federal Home Loan Bank stock equal to 2.0% of individual aggregate unpaid loan principal was reduced to 1.0%.

Payments into the SR were described as "in the nature of a prepayment with respect to future premiums" and become a pool of wealth to be used if the Primary Reserve and earnings are inadequate for meeting obligations of the FSLIC. These obligations may be classified as (1) administration and liquidation expenses, (2) insurance losses, and (3) provisions to the SR accounts of member associations as interest or earnings on accumulated SR payments.

The law further provides that the SR payments are not exchangeable or transferable except by consent of the FSLIC in stipulated types of business combinations. They are not refundable in cash except upon membership termination with the FSLIC, upon liquidation of the enterprise, or at such time as the PR, by itself, accumulates to 2% of the total amount of savings.

Condition For Suspension of Payments. Another provision in the law is that when the combined total of Primary and Secondary Reserves for all member institutions equals or exceeds 2% of total insured savings, such payments will be temporarily suspended until such time as the combined total drops to 1.75%. During this period the annual insurance premium (PR) will be paid by credit from the individual association's pro rata share of the SR to the extent available, rather than by cash. When the combined total drops to 1.75%, payments will be resumed until the combined total once again reaches the 2% level. Fluctuations between 2% and 1.75% will continue until, as mentioned above, the Primary Reserve alone accumulates to 2% of total insured savings. (Original estimations were that this would occur in 1995). At such time, a pro rata cash

refund of the SR will be made to participating associations and SR payments will no longer be required, even if the PR subsequently drops below the 2% level.

THE ASSET TEST

With this background in mind let us proceed to determine whether the prepayments have any asset characteristics. Authorities tend to agree that for an expenditure to be properly classified and recorded as an asset requires (1) an existence of future benefits or service potentials, and (2) that these future benefits accrue to a specific entity. (See references which follow.)

Requiring the existence of future benefits or service potentials is another way of saying that assets are things of value; that they have future usefulness to an entity.[5] When expected future benefits no longer exist or when usefulness to an enterprise is unlikely, an item should be excluded from the assets of that enterprise and should be treated as a current charge against in-

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[5]J. C. Bonbright states that ". . . things are deemed to have value for their supposed capacity to perform services for those persons who can exploit them by exercising the powers of ownership." He further points out that ". . . the value of property is nothing but the value of an opportunity to derive future profits or other services . . ." See *The Valuation of Property*, Vol. I, (McGraw-Hill, 1937), pp. 14, 20 respectively.

Hendriksen indicates that all assets obtain their value to the firm because of their expected contribution to the stream of future earnings and cash flows. Eldon S. Hendriksen, *Accounting Theory*, (Richard D. Irwin, 1965), p. 348.

The American Accounting Association's 1957 Revision states that "assets are economic resources devoted to business purposes within a specific accounting entity; they are aggregates of service —potentials available for or beneficial to expected operations." *Accounting and Reporting Standards for Corporate Financial Statements*, p. 3.

come, regardless of whether this charge is classified as an expense, a loss, or as part of cost of goods sold.[6]

An additional condition to the existence of future benefits or service potentials is that an entity own or have the rights of ownership to the future benefits or service potentials. Unless an enterprise expects to have these potential services available for its use, i.e., is able to exercise ultimate and intermediate control over these potential services, it will derive little, if any, benefit from them and should not include them as part of its assets.[7]

An extension of the second asset characteristic is that there be a legally enforceable claim insuring usability rights.

Services that can be withdrawn at will by some other firm or individual or by the government without compensation should not be included as assets. This does not mean, of course, that the firm must have a formal legal title or even a formal contract. In most cases, the accountant must rely upon the apparent intent of those who may have an interest in the asset rather than on the strict legality of the right.[8]

Thus, assets are viewed here as aggregates of service potential; they are rights to future economic benefits accruing to and controllable by a particular entity.

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[6]"When the service potential of a given asset is no longer available to the enterprise . . . (the) cost of the asset . . . should be eliminated from the accounts . . ." *Ibid.*, p. 5.

[7]Eric Kohler points out that "perhaps the most important characteristic of an asset recognized by the accountant is its usefulness to the owner. An object or right is considered useful if it is the source of, or can be used to secure, future services economically advantageous, not to *any* person, but to its present owner." *A Dictionary for Accountants*, 3rd Edition, (Prentice-Hall, Inc., 1963), p. 42.

[8]Hendricksen, *op. cit.*, pp. 194-195.

When items no longer have any discernible benefit for a particular entity in future periods, they are not assets but are expenses to be charged against current revenues.

Given the above characteristics, do SR payments qualify as assets? Are there future benefits to be derived from these payments? Do such benefits accrue to a specific entity, an individual savings and loan association in this case? Is that entity able to control and use the benefits as needed, or are such benefits subject to withdrawal at will by some other firm or by the government?

Future Benefits from Secondary Reserve Payments? One might initially agree that payments into the Secondary Reserves of the FSLIC do, in a general sense, secure future benefits if they meet these conditions: (1) they can be used to pay future regular (PR) premiums, provided that the combined PR and SR balances are equal to or exceed 2% of total insured savings; (2) they will be fully refunded in the event of discontinuance of insurance, liquidation of the association, or at such time as the Primary Reserve, by itself, equals or exceeds 2% of total insured savings; and (3) they have some characteristics of an investment which earns a return on amounts paid in, although, in this case, the return is not available to the association for its use until some future, indeterminable date. Closer examination reveals, however, that these apparent asset characteristics are illusory and should not govern.

As to the *first condition*, note that SR payments can be used to pay regular premiums only if the Primary and Secondary Reserves combined equal the 2%

criterion. Based on a 1961 estimate of savings growth, this level of 2% of total insured savings was originally projected to be reached in 1970. Later it was estimated that the 2% level would likely occur as late as 1976, based on revised projects prepared by the FSLIC.[9]

Enactment of Public Law 91-151 reduced reserve requirements arbitrarily. This action, in the face of depressed savings and loan association operations during the late 1960's, had the effect of increasing the relative level of reserves, and produced a 2% level by 1970 as originally predicted. Therefore, letters have been mailed by the Federal Home Loan Bank Board informing insured institutions that beginning January 1, 1970, SR payments will be suspended until the aggregate reserves of the FSLIC fall below the 1.75%, and that each institution's pro rata share of the SR, to the extent available, will be used to pay the "annual insurance premium" (PR).

Thus benefits are now being received from prior SR payments made by insured institutions. However, it is interesting to note the combination of circumstances that brought this about. First, the tight money market has cut sharply into funds which individuals are putting into savings and loan associations. This has had the opposite effect from that of the 1950's when insured savings increased rapidly, causing a steady decline in the FSLIC ratio.[10] Second, the law was amended,

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[9]Report of California CPA Committee, *op. cit.*, pp. 19-20.

[10]In 1946, associations held $25 in savings for each $100 in commercial banks' savings and other time deposits. By 1961 the ratio was $85 to $100. Since 1961 there has been a decline to $69 for each $100 in banks. *U. S. News & World Report*, May 11, 1970, p. 95.

reducing the base upon which reserve payments are computed. The change in the law was made because of "potential serious problems" in the savings and loan industry.[11] Thus, at a time when money is tight, business is declining, and the entire industry is faced with serious problems,[12] account protection is increased and reserve requirements are decreased. Certainly, association cash positions will be improved and those savers with larger savings accounts will be better protected.

However, the question still remains: Is not the SR payment an expense of operation, an insurance premium, which has been paid into an insuring organization to bolster public confidence and to provide saving account protection? The mere fact that the FSLIC is a government agency and can be given powers, concessions and considerations not ordinarily available to private institutions does not change the character of an expenditure from that of an expense to that of an asset. Moreover, if the Agency decides in the future to call for SR payments the problem of capitalization or charge-off will reappear.

Realistically, at least so it seems to the writers, the situation is such that reserves should now be increased,

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[11]In November, 1969, officials ranked 18 associations with total assets of $2 billion as "probable candidates for assistance." As of April, 1970, about 15 associations with assets approaching a total of $1 billion are on the Government's list of shaky financial institutions. *The Wall Street Journal,* April 14, 1970.

[12]A prominent savings and loan executive from the Midwest has stated, "we can't go on for long this way. Unless the industry undergoes fundamental changes, it may, indeed, face extinction." The president of the National League of Insured Savings Associations, Paul Westerfield, Chairman of the Home Federal Savings and Loan Association, Cincinnati, also said: "We're probably in a battle for survival. Some will endure and some will not." *U. S. News & World Report,* May 11, 1970, p. 96.

rather than decreased as at present. The original statute called for annual premiums until such time as FSLIC reserves reached 5% of the total amount of all accounts of insured members. A 5% level does not appear excessive when viewed in terms of current economic conditions facing the savings and loan industry. Factors which support this view are: (1) changes in the rate of growth of savings, (2) changes in intermediation or disintermediation and (3) the present attitude of savers who currently are more inclined to go directly into the market.

The *second condition* whereby future benefits might be received is possibility of recovery of the SRs in the event of discontinuance of insurance, liquidation of the association, or at such time as the PR, by itself, equals or exceeds 2% of total insured savings.

Discontinuance of insurance without discontinuing business is virtually impossible. Federal associations cannot, and competition will not permit state associations to do so. If an association were forced to liquidate, asset realizations would likely be reduced significantly and the amount and timing of any SR repayments would be uncertain and not easily predictable.

SR payments are also refundable when the PR alone accumulates to 2% of total insured savings. When the SR program was created in 1961, the PR was approximately 0.66% of insured savings. At December 31, 1967 it was about 0.73%.[13] Growth appears to be

[13]Alan McNaughton, "An Analysis of the Accounting Treatment of Prepayments to the Secondary Reserve of the Federal Savings and Loan Insurance Corporation for Financial Statement Purposes of Insured Savings and Loan Associations," Unpublished manuscript, p. IV-7.

slow. One writer has stated, "assuming a growth in savings accounts of 10 percent annually, the PR balance will reach only approximately 1 percent after 20 years."[14] Of course, if there is no growth in savings and if associations remain solvent and in business, the period might be shortened, a highly unlikely situation. Original calculations indicated an accumulation to 2% by 1995. They were based in part on a no-loss assumption. Losses have been sustained, and although they only represent 80 cases and total to $125.9 million since the FSLIC was created in 1934, it does not follow that losses will continue to be insignificant in total.[15] Losses have increased significantly during the last ten years.[16]

As to the *third condition, investment characteristics of SR payments,* by law the FSLIC is required to credit each member association's SR account with a "return" on such accumulated payments. However, the

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[14]"Deductibility for Income Tax Purposes of Payment to the Secondary Reserve of the Federal Savings and Loan Insurance Corporation," *The Ohio Savings and Loan Record,* (January, 1967, p. 10.)

[15]*The Wall Street Journal,* April 14, 1970.

[16]Actions which may be taken by the FSLIC include: (1) standby agreements to make contributions in the future, e.g., where merger of a weak institution with a stronger one is recommended, (2) purchase of assets, (3) loans, (4) combinations of these methods, and (5) receivership (insurance payment). During the 34 first years of operation of the FSLIC only 12 insurance payments cases have taken place. However, of these 12, one was in 1965, two in 1966, and two in 1968. The cases in 1968 resulted in payments to insured savers of two Chicago savings and loan associations of $119.7 million with pending and unclaimed accounts at year-end of $0.9 million. Another Chicago association with savings account balances of $22.8 million, in a default prevention action, was merged into a fourth Chicago association. A number of merger default prevention actions has taken place within the last few years. (See *36th Annual Report-1968,* Federal Home Loan Bank Board), pp. 54-62.

crediting of this return may be misleading. From the standpoint of realization, revenues do not exist. Realization usually requires a conversion through legal sale or similar process, and that the conversion be validated through the acquisition of liquid assets.[17] These two tests are not met with a mere accounting entry, the recording of a "return" on an association's books. There are no liquid assets available to the association at that point in time; there is nothing the association can use, either to generate revenues or as liquid funds for operating expenditures or for payment of liabilities, except in one case of applying them toward payment of the annual insurance premium when conditions are met which permit this. The only way the returns could be converted into cash for immediate use is by dissolution of the member association or from its withdrawal from the FSLIC, certainly not a normal activity nor in keeping with the going concern concept generally assumed in accounting.

Another basic difference between SR payments to the FSLIC and investments is that investments are usually controllable by the investor. If the investment is unsatisfactory, it can be withdrawn and placed elsewhere. This cannot be done with SR payments. As stated previously, it is only at that point in time when PRs alone equal 2% of insured savings that SRs will be refunded to member associations. Until then they are at all times under the control of the FSLIC.

Even by defining an investment very broadly, SR payments would be considered an involuntary invest-

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[17]W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards,* (American Accounting Association Monograph, November 3, 1962), p. 49.

ment, one which provides no expendable dividend and one over which there is little, if any, control. Thus, considering the above factors, it appears that the FSLIC, not its member associations, exercises control over these payments.

PROPER MATCHING OF REVENUES AND RELATED EXPENSES PRECLUDES CAPITALIZATION.

There is still another factor which the authors feel is pertinent. Classifying SR payments as investment type assets does not provide an appropriate matching of revenue and expense. Generally, the accounting concept of matching requires that costs or expenses be charged against revenues generated by the incurrence of such costs or expenses. That is, that both revenues and their related expenses be reported in the same accounting period in determining income. If SRs are shown as assets and deferred to some future distant accounting period this will not be done. The benefit accrues to the association at the time payment is made to the FSLIC. The association is buying insurance protection for its savers, and when saver protection is assured, public confidence is bolstered. As a result, additional savings normally flow to the savings and loan association. To say that this is not the benefit for which the association pays its insurance premiums, call them reserves or whatever, is a misstatement of fact. The FSLIC is an instrumentality of the federal government created by Congress to insure savings accounts at savings and loan institutions. When FSLIC insurance protection is in force, savers place their funds with a savings and loan association with confidence. Withdraw that protection and the funds will quickly flow

elsewhere. Thus, there is a direct relationship between revenues and these expenditures (expenses) currently, not at some as yet indeterminate future date.

In summary, SR payments made to the FSLIC contribute to saver confidence and the increased cash flows currently. They are not likely to contribute to a stream of future earnings or to cash flows under normal operating conditions. At best they can only reduce far-in-the-future expenditures for savers' account insurance protection.

FEDERAL COURTS AFFIRM EXPENSE CONCEPT

In the Memorandum Opinion of the recent court ruling, Chief Judge Charles B. Fulton stated:

> It is the view of this Court that the only significant difference between the regular premiums (Primary Reserve) and the additional premiums (Secondary Reserve) is the fact that there exists a contingent possibility that the additional premiums may some day be recovered. For reasons which will appear below, this fact does not render the additional premiums non-deductible (as ordinary and necessary business expense for tax purposes). In all other respects, the regular and additional premiums are substantially identical and, in fact, the additional premiums are for all practical purposes nothing more than an increase in the amount of the regular premiums.
>
> Plaintiff's purpose in paying the additional premiums is the same as its purpose in paying the regular premiums. It is required by law to insure its accounts and it must pay both premiums

> in order to maintain the insured status of its accounts. If it fails or refuses to make either the additional or regular premium payments, the FSLIC would terminate its insured status, acting under the provisions of its Regulations, 12 CFR Sec. 565.2. There is no distinction in those regulations between failure to make one payment as opposed to the other. Therefore, with respect to both regular and additional premiums, there exists precisely the same compulsion to pay, the same purpose in paying, and the same consequence of failure to pay. Likewise, in the hands of the FSLIC, the regular premiums (after deducting the portion used for operating expenses) and the additional premiums serve identical functions. They are held as reserves against losses. While two separate reserves are established—Primary Reserve and Secondary Reserve—there is no difference in function between the two reserves, both of which are established for the single purpose of meeting future losses.[18]

Similarly, a decision of the Tax Court of the United States in the Lincoln Savings and Loan Association vs. Commissioner of Internal Revenue was reversed. In essence the court's decision was that SR payments made to the FSLIC by an insured institution are ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.[19]

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[18]Memorandum Opinion of Chief Judge Charles B. Fulton, United States District Court, Southern District of Florida, in the case of Washington Federal Savings and Loan Association of Miami Beach, Plaintiff, vs. United States of America, Defendant. No. 67-266-civ-CF, entered September 26, 1969, pp. 8-9 and p. 10.

[19]In The United States Court of Appeals for the Ninth Circuit.

SUMMARY AND CONCLUSION

In the above discussion, an attempt has been made to point out certain accounting issues relating to the treatment, for accounting and reporting purposes, of Secondary Reserve payments to the FSLIC. On the basis that asset characteristics are lacking and because of the measurement problems involved, the propriety of current practice, which classifies and records SR payments as assets, has been questioned. It follows that: (1) if no benefits from SR payments are anticipated, or (2) if uncertainties are such that benefits may not accrue, or (3) if benefits likely to accrue are so far removed from the present as to make their present worth negligible or nonexistent, it is questionable practice to report as assets those amounts remitted to the FSLIC by savings and loan associations as SR payments.

It would seem that, since projected PR and SR accumulations and balances are based on assumed growth rates, inflationary trends, loss estimates, and many other factors, and since uncertainties as to these and the other factors do exist, SRs, if classified as any type of asset at all, should be classified as contingent assets. As such they would be more realistically reported by footnotes.

Even if it were conceded that SRs have some elements characteristic of assets, reporting such elements at amounts substantially in excess of present values (even assuming minimal rates of interest) may be misleading.

Transfer of control, use, and for all intents and purposes, legal title, seems to indicate that the transfer of funds from a savings and loan association to the

FSLIC does not result in mere transfer of one type of asset for another by the association. Rather, it would seem that it is an expenditure of an asset for services, services which are directly related to providing insurance on depositor's accounts and of providing stability and public confidence in the savings and loan industry.

Essentially, then, the analysis presented in this paper of the basic characteristics of assets, when compared with the intent and nature of SR payments, leads to the conclusion that, for accounting and reporting purposes, these payments should be treated as expenses, not assets. This conclusion has been affirmed in recent Federal court decisions. If future benefits exist, they are so uncertain as to amount and timing as to preclude realistic classification as assets. Capitalizing these payments results in a material overstatement of earnings and earnings per share in the income statement and an overstatement of asset and retained earnings accounts in the balance sheet. It does not result in realistic and fair presentation to financial statement readers.

PROPOSED SOLUTION

The FSLIC is a creation of Congress, created in 1934 by Title IV of the National Housing Act. Since then, legislative amendments have modified the original Act. If the recommendations of this paper were followed, Congress, through legislative action, would once again be required to modify the Act. Included without elaboration as to detail, the plan presented below, if enacted by Congress, would permit realistic and fair presentation of financial data to savings and loan association financial statement readers.

Alternatives which might be followed in disposing of SR accumulations now shown on member associa-

tions' books run from the extremes of an immediate write-off of accumulated amounts to a permanent capitalization in the form of a "stock" investment. Among these alternatives, the writers view the following plan as one which merits consideration.

1. Discontinuance of SR payments; adjustment of the Primary Reserve premium rate so that sufficient funds will be available to meet any FSLIC losses and normal operating expenses.

2. Use of part of the SR accumulated balances to reduce current payments to the PR by member associations. (This would decrease current cash outflow requirements of member associations and would be particularly helpful with the present tight money situation.)

3. Write-off of the remaining balances in the SR accounts against non-operating income over the next five to ten years. (So as to not make the charge too extreme, perhaps settle on a 10 percent write-off per year.)

4. Proforma disclosure of income and earnings per share figures which would have resulted if SR payments had been charged to expense. (This would be a practical modification of requiring retroactive adjustments in the historical financial statements.)